

**THE PUBLIC SERVICE COMMISSION
OF SOUTH CAROLINA**

DOCKET NO. 2021-324-WS

IN RE: Application of Kiawah Island Utility,)	REVISED DIRECT
Incorporated to File Proposed Changes)	TESTIMONY
in Rates, Charges, Classifications)	
and/or Regulations for Water and)	OF
Sewer Service.)	MUJEEB HAFEEZ

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Mujeeb Hafeez. My business address is 12535 Reed Road, Sugar Land, TX 77478.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by SouthWest Water Company ("SouthWest") as Director, FP&A within Corporate Shared Services. I previously was employed by SouthWest as Assistant Controller, in which capacity I'm testifying in this case

Q. BRIEFLY DESCRIBE YOUR DUTIES AS ASSISTANT CONTROLLER.

A. My responsibilities consisted of the following for SouthWest and its subsidiaries, including Kiawah Island Utility, Inc. ("KIU" or "Company"): implementing and maintaining an appropriate system of internal controls; ensuring financial records are maintained in compliance with company policies and U.S. Generally Accepted Accounting Principles ("GAAP"); overseeing the general accounting function; providing technical accounting GAAP guidance and support; overseeing internal and

1 external financial reporting; coordinating SouthWest's annual external audit; and
2 assisting in regulatory proceedings.

3 **Q. BRIEFLY DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL**
4 **BACKGROUND.**

5 A. My educational background consists of a Bachelor of Science in Accounting and a
6 Master of Science in Accounting from the University of Houston. I was previously a
7 Certified Public Accountant in the State of Texas until 2021 at which time I elected to
8 place my license in an inactive status. I have been employed by SouthWest since 2018.
9 My professional background prior to being employed by SouthWest includes eight
10 years of public accounting experience with PricewaterhouseCoopers, LLP ("PwC"), a
11 multinational professional services firm and one of the "Big Four" public accounting
12 firms. While at PwC, I served audit clients with a focus in the regulated investor owned
13 and private equity-owned utilities industry, including SouthWest and KIU.

14 **II. PURPOSE OF DIRECT TESTIMONY**

15 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS**
16 **PROCEEDING?**

17 A. The purpose of my direct testimony in this proceeding is to discuss SouthWest
18 corporate costs and the allocation methodology of those costs across SouthWest's
19 subsidiaries, including KIU. The total SouthWest allocable indirect corporate costs
20 (discussed further below) for the Test Year total \$13.9 million, of which 4.3% or
21 approximately \$598 thousand, is allocated to KIU.

1 **III. OVERVIEW OF SOUTHWEST WATER COMPANY**

2 **Q. BROADLY SPEAKING, HOW ARE SOUTHWEST'S UTILITY OPERATIONS**
3 **ORGANIZED?**

4 A. SouthWest is a private, investor-owned company that, through its subsidiaries,
5 provides water and wastewater utility services to customers throughout the United
6 States. SouthWest's operations are comprised of several business units which are
7 generally disaggregated by geography (e.g. region, state, etc.). The Cost Allocation
8 Manual included with this direct testimony as Attachment MSH-1 describes the
9 methodologies used by SouthWest to allocate costs, which I will also address in this
10 testimony. Additionally, SouthWest's organizational structure depicting its business
11 units and their subsidiary operations is included as Attachment MSH-2.

12 **Q. HOW ARE THE FINANCIAL RESULTS OF SOUTHWEST'S BUSINESS**
13 **UNITS CURRENTLY REPORTED?**

14 A. As of the end of the 2020 Test Year, the financial results of SouthWest's operations
15 were reported by seven business units. Six business units are attributable to operations:
16 Suburban Water Systems ("SWS"), Texas Utilities ("TWU"), Southeast Utilities –
17 Alabama ("SEU-AL"), Southeast Utilities – Palmetto ("SEU-Palmetto), Southeast
18 Utilities – Low Country ("SEU-LC"), and Northwest Utilities ("NWU"). The seventh
19 business unit—Corporate Shared Services—is included in the parent, SouthWest.
20 Corporate Shared Services is comprised largely of indirect costs that benefit
21 SouthWest's utility business units and are not directly traceable to any of them. The
22 indirect costs captured in the Corporate Shared Services business unit are allocated to
23 the utility business units.

1 **IV. INDIRECT COSTS AND ALLOCATION METHODOLOGY**

2 **Q. PLEASE DESCRIBE SOUTHWEST'S COST ALLOCATION MANUAL.**

3 **A.** SouthWest prepared its Cost Allocation Manual in accordance and conformance with
4 the National Association of Regulatory Utility Commissioners' *Guidelines for Cost*
5 *Allocations and Affiliate Transactions* ("NARUC Guidelines"). The foundational
6 principles of the Cost Allocation Manual are to directly charge as much of the incurred
7 costs as possible to the entity that procures any specific service; fairly allocate costs
8 that cannot be directly charged to SouthWest's subsidiaries; and ensure that
9 unauthorized subsidization of unregulated activities by regulated activities, and vice
10 versa, does not occur.

11 **Q. WHAT PRINCIPLES GUIDE THE ALLOCATION OF COSTS?**

12 **A.** As the Cost Allocation Manual provides, the principles that guide the allocation of costs
13 for products or services provided by SouthWest to its affiliates are as follows:

- 14 • To the extent practicable, in consideration of administrative costs, costs should be
15 collected and classified on a direct basis for each asset, service, or product provided;
- 16 • The general method for charging indirect costs should be on a fully allocated, cost-
17 causative allocation basis, without any associated margin or mark-up;
- 18 • All direct and allocated costs should be traceable on the books of the applicable
19 affiliate;
- 20 • Documentation regarding transactions between the regulated utility and its
21 affiliates should be made available for review by the appropriate Commission or
22 other regulatory authority, upon request, to address their reasonable concerns in the

1 exercise of their responsibility to examine any of the costs sought to be recovered
2 by the utility in rate proceedings; and

- 3 • The primary cost driver of common costs, or a relevant proxy in the absence of a
4 primary cost driver, should be identified and used to allocate the cost to all
5 affiliates.

6 **Q. WHAT COSTS ARE CONSIDERED CORPORATE ALLOCABLE INDIRECT**
7 **COSTS AND WHAT ALLOCATION METHODOLOGY IS USED?**

8 A. Indirect costs are those corporate costs that benefit all SouthWest business unit
9 operations and that are so general in nature as to require prorations based on a
10 combination of several pertinent factors. To allocate those costs among the business
11 units, the Cost Allocation Manual describes the three-factor allocation methodology
12 consisting of the following factors weighted equally: 1) gross plant; 2) operating
13 expenses including payroll expenses (e.g. salaries and wages, payroll taxes, etc.); and
14 3) payroll expenses.

15 **Q. SPECIFICALLY, IN WHICH AREAS ARE INDIRECT COSTS INCURRED,**
16 **FOR WHAT PURPOSE, AND WHAT IS THEIR MAGNITUDE?**

17 A. As noted in SouthWest's Cost Allocation Manual, indirect costs are attributable to the
18 following corporate functions, which are essential in providing effective utility service:
19 1) executive & corporate development ("CD"); 2) legal; 3) information technology; 4)
20 human resources; 5) facilities; and 6) finance. The allocable indirect corporate costs
21 for the Test Year total \$13.9 million and are shown by corporate function in Attachment
22 MSH-3.

1 **Q. IS THE \$13.9 MILLION IN CORPORATE COSTS REASONABLE?**

2 A. Yes. As described more fully below, these costs are essential to the successful
3 operation of KIU, and—due to the shared services model—are more economic for KIU
4 to obtain via its corporate parent than would be possible on the open market. Details
5 of the services provided by corporate shared services benefitting KIU’s customers are
6 discussed below.

7 **Q. PLEASE SUMMARIZE THE BENEFITS THAT CUSTOMERS ACCRUE AS A**
8 **RESULT OF USING SOUTHWEST’S CORPORATE SHARED SERVICES.**

9 A. Corporate provides shared services more effectively and efficiently than could be
10 provided to the individual affiliates individually. Customers benefit from economies
11 of scale from the shared services model. Additionally, the costs of SouthWest’s
12 Corporate Shared Services are allocated to subsidiaries without any associated margin
13 or mark-up.

14 **Q. PLEASE DESCRIBE THE INDIRECT CORPORATE SHARED SERVICES**
15 **AND THEIR COSTS THAT SOUTHWEST ALLOCATES TO ITS**
16 **AFFILIATES.**

17 A. Broad categories of costs being allocated are Executive & CD, Legal, Information
18 Technology, Finance, Human Resources, and Facilities. A review of Attachment
19 MSH-3 shows that the Executive & CD function accounts for \$4.762 million (34.3%),
20 the Finance function for \$4.007 million (28.8%), and the Information Technology
21 function for \$3.392 million (24.4%). The combined cost of Legal, Human Resources,
22 and Facilities is \$1.735 million (12.5%). SouthWest’s Corporate Shared Services
23 business unit includes a total of 48 employees for the Test Year. Information

1 Technology has the greatest number employees with 19, followed by Finance with 18,
2 and Executive & CD with 9. Human Resources and Facilities each have one employee.
3 A discussion of each function's responsibilities and indirect costs follows below.

4 **A. Executive & CD**

5 The executive portion of this function is responsible for providing strategic vision and
6 guidance, business strategy and development, executive management and oversight,
7 and the overall direction of the company. The executive function consists of the Board
8 of Directors and a core group of four senior executives; the Chief Executive Officer,
9 Chief Operating Officer, Chief Financial Officer, and General Counsel. Additionally,
10 the executive function includes an administrative assistant who is responsible for
11 providing administrative support to the executive team. These employees are integral
12 and indispensable members of this group.

13 The CD portion of this function is responsible for promoting company growth
14 and consists of an executive vice president, two directors, and an analyst. Company
15 growth benefits existing customers through myriad ways, but most specifically in
16 reducing the allocated portion of shared costs. As an example, the three-factor
17 allocation to KIU was 5.2% at the time of KIU's last rate case. In the current
18 application, the three-factor allocation percentage is now 4.3%, which represents a
19 decrease of 0.9%, or an approximate reduction of \$125 thousand of Test Year corporate
20 costs allocated to KIU.

21 Not as easily quantifiable but important nonetheless, company growth achieved
22 through CD improves operational efficiencies as well, as larger water and wastewater
23 facilities tend to be more efficient and less likely to experience operational issues,

1 technology initiatives are more affordable and easily implemented for a larger number
2 of customers, and larger utilities generally enjoy stronger buying power. Additionally,
3 employees are more likely to feel better about being part of a growing company,
4 ultimately reducing turnover.

5 The Test Year cost attributable to the executive & CD function was \$4.762
6 million. Approximately \$3.873 million represents payroll and benefits for this
7 function, or 81.3% of the total. Based on a January 2021 Willis Towers Watson
8 Executive Benchmarking Study, total direct compensation provided to the four senior
9 executives (which includes total incentive compensation), when viewed against the
10 market for talent for executives in similar positions, is within the median market
11 competitive range. Elements of the executive compensation program include base
12 salary, short-term at-risk compensation, and long-term at-risk compensation. A portion
13 of the short-term at-risk compensation, and all of the long-term at-risk compensation is
14 based on financial measures. Although total compensation, including the consideration
15 of all incentive compensation, is within the median market competitive range, incentive
16 compensation based on financial measures has been excluded from the Test Year costs.

17 Approximately \$695,000 represents the Board of Directors' fees for six paid
18 board members, or 14.6% of the total. Based on a September 2020 Willis Towers
19 Watson Outside Director Pay Review Study, when compared against comparable peer
20 organizations for which compensation data are available from publicly disclosed
21 proxies, SouthWest's board of directors are paid below market median. Approximately
22 \$117,000 consists of the cost of insurance representing approximately 2.5% of the total
23 cost. The cost of insurance represents the cost for Directors and Officers and Broad

Form Side A, Crime, Cyber Liability, Employment Practices Liability, Property, and broker's fees. Regarding the Directors and Officers and Broad Form Side A insurance, there is risk in the form of legal liability inherent in director and officer positions. No one would serve in these positions unless they were adequately insured against such risk. Therefore, the cost of such insurance is indispensable as a cost of the executive function. Together, these indispensable cost components (payroll and benefits, director fees, and insurance) amount to 98.4% of the total cost of this function. The total costs of \$4.762 million represents a necessary and reasonable cost for SouthWest with respect to the executive & CD function.

B. Legal

The Legal function is responsible for:

- corporate governance;
- transactional, employment, and real estate law;
- litigation;
- general legal affairs; and
- management of outside counsel.

The shared legal resources of SouthWest consist of only the General Counsel. The cost of this position is included in the Executive & CD function described above as the General Counsel also serves as an executive of SouthWest. Therefore, this represents an efficient structure to address the responsibilities of this function.

The adjusted recorded cost of the legal function in the Test Year was approximately \$124,000. The legal costs incurred at the corporate level for general corporate matters totaled approximately \$79,000 in the Test Year.

1 One of the most important functions of the General Counsel is managing and
2 administering the efforts and costs of outside counsel. On an ongoing basis, SouthWest
3 has a number of legal matters that are assigned to various outside counsel. It would not
4 be possible for the General Counsel alone to address the volume of litigation, and it
5 would be financially prohibitive to employ the number of in-house counsel that would
6 be needed to address all these legal matters. Therefore, reliance on outside counsel is
7 an efficient way to address many of SouthWest's legal matters.

8 The cost of outside legal fees attributable to legal matters affecting all
9 SouthWest subsidiaries is subject to wide variation depending upon the number and
10 magnitude of legal issues that arise and their cost to effectively litigate.

11 **C. Information Technology**

12 The information technology ("IT") function is responsible for identifying,
13 implementing, and maintaining advanced and cost-effective systems solutions in
14 support of SouthWest business. This function is comprised of four groups as follows:

- 15 • Administration—Responsible for working with business units and vendors
16 to ensure the highest quality of services to support business operations.
17 Also develops short and long-range technology objectives, provides
18 contract and project management, evaluates company business goals and
19 objectives, and supports business units from a technology advisory
20 standpoint;
- 21 • Infrastructure, Network, and Computer Desktop Support - Responsible for
22 the planning, architecture, implementation, administration, and support of
23 company data, telecommunications, wide area network infrastructure, and

1 database servers. Also provides frontline desktop and helpdesk technical
2 support, procurement and management of IT assets and serve as the primary
3 point of contact for end users and their computer or system needs;

- 4 • Information and Cyber Security - Responsible for the security configuration
5 of all enterprise systems, IT governance and controls, and risk mitigation.
6 Also develops and configures security roles in all enterprise systems,
7 creates and terminates users, performs password resets, and configures
8 permissions on Outlook public folders and servers. This function monitors
9 automated and manual malicious attacks of company, employee, and
10 customer information assets and identifies, analyzes, and mitigates
11 associated risks; and
- 12 • Business Applications - Responsible for managing the ongoing
13 systems-related business processes, administration, development and
14 project management for company System Applications and Products in
15 Data Processing ("SAP") enterprise system to include: 1) the core functions
16 of financials, material management, sales and distribution, human
17 resources, payroll and benefits; 2) the industry specific solutions for utilities
18 functions for accounts, meters and meter reading, bill and bill print, and
19 customer relationship management; and 3) business reporting tools. Also
20 responsible for the configuration and maintenance of customer-facing
21 billing and payment applications to ensure the ease-of-use process for
22 customers to view and provide payment for their bills.

1 The total headcount for the Information Technology function is 19. These 19
2 employees are responsible for the IT function and reside at the corporate level. This
3 headcount is assigned to the various IT functions noted above as follows:

- 4 • Administration (1)—Consisting of the Vice President of IT who is
5 responsible for the total IT function;
- 6 • Infrastructure (5)—Consisting of a Manager of Telecommunications, one
7 SAP DBA and Basis Administrator, one Desktop Support Analyst, one
8 Telecommunications Analyst, and one Webmaster;
- 9 • Cyber Security (2)—Consisting of a manager of Infrastructure and a
10 Security Analyst; and
- 11 • Business Applications (11)—Consisting of an IT Director, IT Project
12 Manager, Manager SAP Solution Architect, two Functional Team Leads,
13 one SAP ABAP ISU/CCS Programmer, and five SAP Functional Analysts
14 responsible for various functions within the SAP system.

15 SouthWest maintains minimal headcount for these IT functional areas while
16 still addressing the responsibilities of the various IT functions. Therefore, a headcount
17 of 19 employees represents an efficient manner to accomplish the responsibilities
18 within the various IT functions. No IT resources are directly employed by KIU.
19 Responsibility for overall IT systems and related IT functions in support of these
20 systems (including desktop and computer hardware and server support) are totally
21 centralized and accounted for as allocable indirect costs. The importance of the IT
22 function and ultimate benefit to customers cannot be overemphasized in that essentially
23 every aspect of SouthWest, its subsidiary utilities, and ultimately rate payers rely on IT

1 systems and telecommunications. SouthWest realizes that IT is critically important to
2 customers and manages these costs closely. The computer and telecommunications
3 infrastructure and support provided by the IT function is right for SouthWest for the
4 following reasons:

- 5 • To conduct business and address customer requirements, SouthWest
6 requires a skilled and dependable IT function in the areas of
7 Infrastructure/Telecommunications/Desktop Support, Applications, and
8 Cyber Security;
- 9 • Southwest has made a commitment to leveraging a modern applications
10 infrastructure in SAP and also to employing skilled internal resources to
11 efficiently support customer needs and as a result requires fewer resources
12 to execute manual processes;
- 13 • SouthWest is sensitive to the modern reality of manual and automated
14 threats affecting Cyber Security associated with its business applications
15 like SAP and Email, as well as its operational technologies such as
16 supervisory control and data acquisition (“SCADA”); and
- 17 • The SouthWest IT platform for Telecommunications and Infrastructure,
18 Cyber Security, and Applications that exists is a stable, reliable and state of
19 the art computing platform that supports business and customer
20 requirements not only for current needs, but also provides a platform for
21 growth in the future.

22 The adjusted recorded cost attributable to the IT function in the Test Year was
23 \$3.392 million. Approximately \$2.153 million (63.5%) represents payroll and benefits

(net of capitalized direct labor). Incentive compensation based on financial measures has been excluded from Test Year costs.

In addition to payroll and benefits, significant core non-payroll costs are associated with IT functions. These core ongoing costs are attributable to facilities, data circuitry and connectivity, voice and data network lines, hardware and software licensing and maintenance costs, laptops, copiers, printers, and mobile communication devices. The remaining \$1.240 million of costs in the IT function relate to these activities. The \$3.392 million represents a necessary and reasonable cost for SouthWest regarding the IT function.

D. Finance

The Finance function is responsible for the accurate and timely accounting for corporate transactions, the accurate and timely preparation of financial statements, preparation of budgets and forecasts, accounts payable, treasury, capital structure, risk management, audit, tax, and providing management with the financial information necessary for informed operating and financial decision making.

For the Test Year, a total of 18 employees were devoted to the various efforts within the Finance function. This headcount consists of the following:

- Accounting (6) - Controller, Assistant Controller, Manager, Senior Accountant, Senior Accountant, Clerk;
- Payroll (2) - Manager, Specialist;
- Accounts Payable (2) - Manager, Clerk;
- Financial Planning & Treasury (6) - Vice President, Treasury Director, Planning Director, Manager, Financial Analyst, Treasury Analyst;

- Tax (1) - Director; and
- Internal Audit (1) - Director.

There are no consolidated functions at any of the subsidiary levels; i.e. accounting, payroll, accounts payable, treasury, risk management, tax or audit function. All of these consolidated functions are indispensable and are performed appropriately at the corporate level. The 18 employees within the Finance function are a reasonable number for the activities for which they are responsible and represent an efficient headcount to address the various responsibilities.

The adjusted recorded cost attributable to the Finance function in the Test Year was \$4.006 million. Approximately \$3.098 million (77.3%) represents payroll and benefits. Incentive compensation based on financial measures has been excluded from Test Year costs. The cost of SouthWest's annual audit performed by PwC and tax work performed by RSM US LLP and Delta Property Tax Advisors is approximately \$489,000 (12.2%). Annual audits are mandatory under SouthWest credit agreements. Bank charges and rating agency charges were approximately \$177,000 (4.4%). SouthWest's banks provide an indispensable service at competitive fees for processing cash receipts and payments and providing computer access for monitoring, managing, and facilitating the movement of cash. Additionally, the cost of an annual rating on SouthWest's debt is necessitated by a covenant in each such debt agreement to maintain a rating. Together, the cost of finance staff, mandatory annual audits and tax filings, bank charges, and credit rating agency charges represent 93.9% of the cost of this function. SouthWest seeks to acquire and retain an efficient and talented finance staff at competitive compensation. SouthWest negotiates reasonable pricing for mandatory

1 annual audits, tax work, and indispensable banking and credit rating agency services.
2 Therefore, the total cost of \$4.006 million represents a reasonable and necessary cost
3 for the finance function.

4 **E. Human Resources**

5 The Human Resources function is responsible for effective policies and procedures in
6 support of the workplace and SouthWest in operation of the business, talent acquisition
7 and retention, management of employee benefit programs, employee and
8 organizational development, compensation administration, succession planning, and
9 rewards and recognition programs that drive performance. The Human Resources
10 function consists of one Vice President, which is an efficient staffing level.

11 The adjusted recorded cost attributable to the Human Resources function in the
12 Test Year was \$1.036 million. These costs consist primarily of payroll and outside
13 services. The level of payroll and benefits is appropriate. Incentive compensation
14 based on financial measures has been excluded from Test Year costs. The outside
15 services consist of professional fees attributable to various consultants and vendors who
16 provide professional advisory, administration, training, and financial services and are
17 indispensable in support of the human resources functions. Together, payroll and
18 outside services amount to 90.2% of the total cost of this function. The remaining 9.8%
19 of costs relate to employee education and other general and administrative costs.
20 Therefore, the \$1.036 million cost for Human Resources and the indispensable outside
21 services on which this function relies is a reasonable and necessary cost for SouthWest
22 regarding the Human Resources function.

1 **F. Facilities**

2 The Facilities function is responsible for maintenance and operation of a two -story
3 32,000 sq. ft. corporate office located in Sugar Land, Texas (the Reed Road Facility)
4 and an 8,400 sq. ft. consolidated records retention facility located nearby (the Eldridge
5 Road Facility). A discussion of these facilities follows:

6 **1. Reed Road Facility**

7 In March of 2001, the corporate office facility on Reed Road in Sugar Land,
8 Texas, was leased for a 25-year period ending in February 2026. The base rent portion
9 of the lease makes provision for periodic increases in monthly rental payments over the
10 term of the lease. The lease expense for the Reed Road facility for the Test Year is
11 approximately \$408,000. For reference, an image of the Reed Road facility is shown
12 below:



1 SouthWest subleases a portion of its corporate office space to its Texas Utilities
2 business unit at a Test Year cost of approximately \$230,000 (inclusive of utilities,
3 maintenance and repairs, property tax, property insurance). Net of the lease payments
4 associated with this sublease, SouthWest's lease expense subject to indirect cost
5 allocation for the Test year is approximately \$178,000.

6 Repair and maintenance for the Test Year was \$121,000. SouthWest's property
7 tax for the facilities function totaled \$64,000. Utilities for the corporate office was
8 approximately \$42,000.

9 2. Eldridge Road Facility

10 In February 2013, SouthWest entered into lease agreements for warehouse
11 space on Eldridge Road in Sugar Land for records retention. The initial leases have
12 been regularly extended. Lease expenses for the Test Year totaled approximately
13 \$58,000. Utilities and repair and maintenance for the Test Year totaled approximately
14 \$5,000.

15 Net annual costs for both the Reed Road and Eldridge Road facilities for the
16 Test Year totaled \$468,000 (\$405,000 for Reed Road and \$63,000 for Eldridge Road).

17 The Facilities function consists of one person at the senior maintenance
18 technician level who is responsible for the daily maintenance and operation of these
19 facilities. One senior facilities and maintenance technician is the minimum and
20 therefore is an efficient headcount for the facilities function to address the
21 responsibilities of this function.

22 The adjusted recorded cost attributable to the Facilities function for the Test
23 Year was approximately \$576,000. Approximately \$562,000, or 97.6%, represents the

net cost of rent, utilities, maintenance and repair, and property taxes for the Reed Road and Eldridge Road facilities and payroll and benefits for a senior maintenance technician. The total costs of \$576,000 represent a reasonable and necessary cost for SouthWest with respect to the facilities function.

V. ALLOCATION OF ALLOWABLE INDIRECT COSTS

Q. WHAT METHOD DID SOUTHWEST USE TO ALLOCATE THE INDIRECT COSTS DISCUSSED ABOVE?

A. SouthWest incurs two types of costs that are passed on to its affiliates: 1) SouthWest's costs that directly benefit a particular affiliate, which are directly identifiable with that affiliate (direct costs); and 2) SouthWest's costs that are not identifiable with particular affiliates and that benefit all or multiple affiliates (indirect costs). Indirect costs are generally allocated by the three-factor methodology or to a much lesser extent, a specific methodology.

The three-factor methodology is used to allocate the vast majority of Corporate Shared Services costs that are either not directly assigned to an affiliate or are not subject to any of the specific allocation methodologies. SouthWest uses the following factors, equally weighted:

- Gross Plant;
- Operating Expenses Including Payroll Expenses; and
- Payroll Expenses.

The application of the three-factor methodology for the Test Year is shown in Attachment MSH-4. The three-factor method for allocating corporate indirect costs

1 resulted in an allocation of \$598 thousand to KIU for the Test Year based on an
2 allocation factor of 4.3% (see Attachment MSH-4).

3 As noted above, to a much lesser extent, some of SouthWest's indirect costs are
4 allocated using specific allocation methods in the alternative to the -three factor
5 allocation method. Indirect costs allocated using a specific allocation method are
6 limited to premiums for consolidated insurance coverages, bank earnings allowances,
7 employee medical insurance administrative charges, employee dental insurance, and
8 IT maintenance costs. The specific allocation methods for these indirect costs are fully
9 described in the SouthWest Cost Allocation Manual.

10 **VI. INSURANCE COSTS**

11 **Q. WHAT KINDS OF INSURANCE DOES SOUTHWEST RETAIN?**

12 A. SouthWest has identified risks to its assets, income, employees, information systems,
13 and management, as well as the environment and third parties. To mitigate the potential
14 financial loss associated with these risks, SouthWest has chosen to transfer a portion of
15 these risks to the insurance marketplace. SouthWest pays premiums to carriers in the
16 marketplace in return for their acceptance of these transferred risks.

17 SouthWest retains various types of consolidated insurance coverages to ensure
18 business sustainability including workers' compensation, auto, primary, umbrella,
19 premises pollution, property, employment practices, cyber technology, crime, directors
20 and officers, and broad form Side A. SouthWest's subsidiaries, including KIU, benefit
21 from the economies of scale achieved by obtaining consolidated coverages, rather than
22 each of its affiliates obtaining separate policies. The consolidated insurance premiums

1 and related broker fees are indirect costs that are allocated using a specific
2 methodology.

3 **Q. WHAT METHODOLOGIES ARE USED TO ALLOCATE INSURANCE**
4 **COSTS?**

5 A. As detailed in SouthWest's Cost Allocation Manual, costs of insurance coverages are
6 allocated to affiliates based on the cost driver that determines the pricing of that
7 particular policy. For example, property insurance costs are allocated based on the
8 affiliate's proportion of property value relative to the whole. Certain coverages (e.g.,
9 directors and officers, crime, and broad form Side A) function primarily at the corporate
10 level; therefore, the premiums for these policies are allocated entirely to SouthWest
11 corporate for further reallocation to SouthWest subsidiaries using the three-factor
12 method.

13 **VII. APPROPRIATENESS OF ALLOCATION METHODS**

14 **Q. PLEASE EXPLAIN WHY SOUTHWEST'S ALLOCATION**
15 **METHODOLOGIES ARE AN APPROPRIATE METHOD FOR**
16 **ALLOCATING THE INDIRECT COSTS DISCUSSED ABOVE.**

17 A. Based on its combination of regulated and non-regulated affiliates, an allocator
18 comprised of the three factors and the specific allocation methods described above best
19 reflect the underlying cost drivers associated with the circumstances and business
20 model of SouthWest and its subsidiaries.

1 Q. ARE SOUTHWEST'S ALLOCATION METHODOLOGIES USED
2 CONSISTENTLY AMONG ALL OF ITS SUBSIDIARIES INSIDE AND
3 OUTSIDE OF SOUTH CAROLINA?

4 A. SouthWest employs the same allocation methodologies for allocating indirect
5 corporate costs in all its operating jurisdictions.

6 Q. DOES SOUTHWEST PROVIDE SERVICES TO ANY UNAFFILIATED
7 PERSONS OR CORPORATIONS?

8 A. No. SouthWest serves solely as a corporate parent to its subsidiaries and provides no
9 services to any third parties.

10 **VIII. CONCLUSION**

11 Q. DOES THIS CONCLUDE YOUR PREPARED TESTIMONY?

12 A. Yes.